

§ 1.171-4

26 CFR Ch. I (4-1-99 Edition)

However, under § 1.171-2(a)(4)(i)(A), E may deduct as bond premium \$958.81, the excess of the bond premium allocable to the accrual period (\$958.81) over the qualified stated interest allocable to the accrual period (\$0). For the accrual period ending on March 1, 2002, the bond premium allocable to the accrual period (\$1,055.82) exceeds the qualified stated interest allocable to the accrual period (\$0) and, therefore, E does not have interest income for the accrual period. Under § 1.171-2(a)(4)(i)(A), E's deduction for bond premium for the accrual period is limited to

\$170.48, the excess of E's total interest inclusions on the bond in prior accrual periods (\$1,129.29) over the total amount treated by E as a bond premium deduction in prior accrual periods (\$958.81). Under § 1.171-2(a)(4)(i)(B), E must carry forward the remaining \$885.34 of bond premium allocable to the period ending March 1, 2002, and treat it as bond premium allocable to the period ending March 1, 2003. The amount E includes in income for each accrual period is shown in the following schedule:

Accrual period ending	Qualified stated interest	Premium allocable to accrual period	Interest income	Premium deduction	Premium carryforward
3/1/00	\$2,000.00	\$870.71	\$1,129.29	.....	.....
3/1/01	0.00	958.81	0.00	\$958.81	.....
3/1/02	0.00	1,055.82	0.00	170.48	\$885.34
3/1/03	10,000.00	1,162.64	7,951.93	.....	.....
3/1/04	8,000.00	1,280.27	6,719.73	.....	.....
3/1/05	12,000.00	1,409.80	10,590.20	.....	.....
3/1/06	15,000.00	1,552.44	13,447.56	.....	.....
3/1/07	8,500.00	1,709.51	6,790.49	.....	.....
.....	.....	10,000.00	.....	.....	.....

Example 2. Partial call that results in a pro-rata prepayment—(i) Facts. On April 1, 1999, M purchases for \$110,000 N's taxable bond maturing on April 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$10,000, payable on April 1 of each year. N has the option to call all or part of the bond on April 1, 2001, at a 5 percent premium over the principal amount. M uses the cash receipts and disbursements method of accounting.

(ii) **Determination of yield and the remaining payment schedule.** M's yield determined without regard to the call option is 8.07 percent, compounded annually. M's yield determined by assuming N exercises its call option is 6.89 percent, compounded annually. Under paragraph (c)(4)(ii)(A) of this section, it is assumed N will not exercise the call option because exercising the option would minimize M's yield. Thus, for purposes of determining and amortizing bond premium, the bond is assumed to be a seven-year bond with a single principal payment at maturity of \$100,000.

(iii) **Amount of bond premium.** The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is \$100,000. Under § 1.171-1, the amount of bond premium is \$10,000 (\$110,000 - \$100,000).

(iv) **Bond premium allocable to the first two accrual periods.** For the accrual period ending on April 1, 2000, M includes in income \$8,881.83, the qualified stated interest allo-

cable to the period (\$10,000) offset with bond premium allocable to the period (\$1,118.17). The adjusted acquisition price on April 1, 2000, is \$108,881.83 (\$110,000 - \$1,118.17). For the accrual period ending on April 1, 2001, M includes in income \$8,791.54, the qualified stated interest allocable to the period (\$10,000) offset with bond premium allocable to the period (\$1,208.46). The adjusted acquisition price on April 1, 2001, is \$107,673.37 (\$108,881.83 - \$1,208.46).

(v) **Partial call.** Assume N calls one-half of M's bond for \$52,500 on April 1, 2001. Because it was assumed the call would not be exercised, the call is a change in circumstances. However, the partial call is also a pro-rata prepayment within the meaning of § 1.1275-2(f)(2). As a result, the call is treated as a retirement of one-half of the bond. Under paragraph (c)(5)(ii) of this section, M may deduct \$1,336.68, the excess of its adjusted acquisition price in the retired portion of the bond (\$107,673.37/2, or \$53,836.68) over the amount received on redemption (\$52,500). M's adjusted basis in the portion of the bond that remains outstanding is \$53,836.68 (\$107,673.37 - \$53,836.68).

[T.D. 8746, 62 FR 68180, Dec. 31, 1997]

§ 1.171-4 Election to amortize bond premium on taxable bonds.

(a) **Time and manner of making the election—(1) In general.** A holder makes the election to amortize bond premium by offsetting interest income with bond premium in the holder's timely filed

federal income tax return for the first taxable year to which the holder desires the election to apply. The holder should attach to the return a statement that the holder is making the election under this section.

(2) *Coordination with OID election.* If a holder makes an election under § 1.1272-3 for a bond with bond premium, the holder is deemed to have made the election under this section.

(b) *Scope of election.* The election under this section applies to all taxable bonds held during or after the taxable year for which the election is made.

(c) *Election to amortize made in a subsequent taxable year—(1) In general.* If a holder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.

(2) *Example.* The following example illustrates the rule of this paragraph (c):

Example. (i) *Facts.* On May 1, 1999, C purchases for \$130,000 a taxable bond maturing on May 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$15,000, payable on May 1 of each year. C uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year. C has not previously elected to amortize bond premium, but does so for 2002.

(ii) *Amount to amortize.* C's basis for determining loss on the sale or exchange of the bond is \$130,000. Thus, under § 1.171-1, the amount of bond premium is \$30,000. Under § 1.171-2, if a bond premium election were in effect for the prior taxable years, C would have amortized \$3,257.44 of bond premium on May 1, 2000, and \$3,551.68 of bond premium on May 1, 2001, based on annual accrual periods ending on May 1. Thus, for 2002 and future years to which the election applies, C may amortize only \$23,190.88 (\$30,000 - \$3,257.44 - \$3,551.68).

(d) *Revocation of election.* The election under this section may not be revoked unless approved by the Commissioner. Because a revocation of the election is a change in accounting method, a taxpayer must follow the rules under § 1.446-1(e)(3)(i) to request the Commissioner's consent to revoke the election. A revocation of the election applies to all taxable bonds held during or after

the taxable year for which the revocation is effective. The holder may not amortize any remaining bond premium on bonds held at the beginning of the taxable year for which the revocation is effective. Therefore, no adjustment under section 481 is allowed upon the revocation of the election because no items of income or deduction are omitted or duplicated.

[T.D. 8746, 62 FR 68182, Dec. 31, 1997]

§ 1.171-5 Effective date and transition rules.

(a) *Effective date—(1) In general.* Sections 1.171-1 through 1.171-4 apply to bonds acquired on or after March 2, 1998. However, if a holder makes the election under § 1.171-4 for the taxable year containing March 2, 1998, or any subsequent taxable year, §§ 1.171-1 through 1.171-4 apply to bonds held on or after the first day of the taxable year in which the election is made.

(2) *Transition rule for use of constant yield.* Notwithstanding paragraph (a)(1) of this section, § 1.171-2(a)(3) (providing that the bond premium allocable to an accrual period is determined with reference to a constant yield) does not apply to a bond issued before September 28, 1985.

(b) *Coordination with existing election.* A holder is deemed to have made the election under § 1.171-4 for the taxable year containing March 2, 1998, if the holder elected to amortize bond premium under section 171 and that election is effective on March 2, 1998. If the holder is deemed to have made the election under § 1.171-4 for the taxable year containing March 2, 1998, §§ 1.171-1 through 1.171-4 apply to bonds acquired on or after the first day of that taxable year. See § 1.171-4(d) for rules relating to a revocation of an election under section 171.

(c) *Accounting method changes—(1) Consent to change.* A holder required to change its method of accounting for bond premium to comply with §§ 1.171-1 through 1.171-3 must secure the consent of the Commissioner in accordance with the requirements of § 1.446-1(e). Paragraph (c)(2) of this section provides the Commissioner's automatic consent for certain changes. A holder making the election under § 1.171-4 does